

FLORIDA BECOMES FIRST STATE TO ENACT STATUTE AUTHORIZING WAIVER OR REDUCTION OF COLLATERAL REQUIREMENTS FOR NON-U.S. REINSURERS

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Florida is the first state to enact a statute authorizing waiver or reduction of collateral requirements for non-U.S. reinsurers. However, implementation of Florida's new collateral requirements law may prove to be challenging for both the regulator and the insurance industry.

I. Development of Florida's New Statute - Influencing Factors

Florida's move to waive or reduce collateral requirements for non-U.S. reinsurers was heavily influenced by Florida's property insurance market following the 2004 and 2005 hurricane seasons and the on-going debate at the NAIC regarding reinsurance regulation and collateral requirements. In 2005, the Florida Legislature created the Task Force on Long-Term Solutions for Florida's Hurricane Insurance (hereinafter referred to as the "Florida Task Force").¹ The Florida Task Force was directed to make recommendations to Florida's legislative and executive branches regarding Florida's property insurance market to ensure that sufficient capacity remained in both the private and public sectors for the availability of insurance coverage for hurricane losses in the State.² The Florida Task Force was provided an overview of the global reinsurance market and the importance of reinsurance in the Florida property market, with particular emphasis on developing issues in the marketplace and the price sensitive nature of the market.³ Furthermore, the Florida Task Force was informed concerning then prevailing statutory accounting rules requiring non-U.S. reinsurers to fully collateralize risks they reinsure through trust or letters of credit within the U.S. and the NAIC's examination of the collateralization issue through its Reinsurance Task Force of the Financial Condition (E) Committee.⁴ At the conclusion of the Florida Task Force's deliberations, it issued a report recommending, among other things, that the Florida Office of Insurance Regulation, through its leadership position within the NAIC, seek to remove any arbitrary, artificial barriers to competition in the reinsurance market without jeopardizing solvency.⁵

Contemporaneously with the Florida Task Force's activities, the NAIC issued its U.S. Reinsurance Collateral White Paper (hereinafter referred to as the "White Paper") summarizing the historical arguments for and against amending U.S. reinsurance collateral requirements. The White Paper provided the Reinsurance Task Force with a basis for public policy recommendations intended to address future developments concerning collateral requirements.⁶ At the Spring 2006 NAIC national meeting, the Reinsurance Task Force was charged to: 1) develop alternatives to the current reinsurance regulatory framework, including the use of collateral within the U.S and abroad; 2) consider approaches that account for a reinsurer's financial strength regardless of domicile; 3) consider and identify variations of state regulation relative to reinsurance contracts and financial reporting; 4) consult with international regulators in addition to all interested parties; and, 5) present a proposal to the NAIC at its December 2006 national meeting.⁷

At the NAIC December 2006 National Meeting, the Reinsurance Task Force presented the Reinsurance Evaluation Office Proposal Procedure to Grant Credit for Ceded Reinsurance (hereinafter referred to as the "NAIC REO Proposal"). The NAIC REO Proposal seeks to establish a regulatory system that distinguishes financially strong reinsurers from weak reinsurers, without relying exclusively on their state or country of domicile, with collateral to be determined as appropriate.⁸ The NAIC REO Proposal would create an organization called the Reinsurance Evaluation Office (REO) to rate the financial strength of reinsurers doing

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business in the U.S., irrespective of the reinsurer's country of domicile.⁹ State insurance regulators, through the REO, would establish procedures for evaluating the financial strength and operating integrity of reinsurers and, based on the outcome of the evaluation, assign a rating (REO-1 through REO-5) to each reinsurer.¹⁰ These ratings would be affirmed or modified through periodic reviews by the REO.¹¹ The analysis would incorporate insurance financial strength ratings assigned by nationally recognized statistical rating organizations ("NRSRO's") and the expertise of the NAIC for evaluating other key factors delineated in the proposal.¹² The analysis would also include a review of the financial strength and operating integrity, business operations, claims paying history, management expertise and overall performance of reinsurers in assigning ratings ("credit criteria").¹³ The amount of collateral posted by each reinsurer would depend on the rating it receives from the REO.¹⁴

II. Florida's Regulation of Credit for Reinsurance and Collateral Requirements

Before Florida's 2007 statutory amendment, Florida regulated credit for reinsurance and the reinsurance activities of reinsurers by allowing domestic ceding insurers to take statutory credit to reduce liabilities by the amount ceded to reinsurers, or paid loss claim amounts recoverable from reinsurers as an asset on its balance sheet.¹⁵ Specifically, credit for reinsurance was allowed when the reinsurer was licensed in the same state of domicile as the ceding company for a like kind of business or if the reinsurer was accredited by the State of Florida.¹⁶ Credit for reinsurance was also allowed if the reinsurer maintained a trust fund in a qualified U.S. financial institution for the payment of valid claims of its U.S. ceding insurers and their assigns and successors in interest.¹⁷ Finally, credit for reinsurance was allowed when reinsurance was ceded to an assuming insurer not meeting the above-referenced requirements, but only as to the insurance of risks located in jurisdictions in which the reinsurance is required to be purchased by a particular entity by applicable law or regulation of that jurisdiction.¹⁸

Effective January 25, 2007, section 624.610(3)(e), Florida Statutes, was created to authorize the Florida Office of Insurance Regulation to waive or reduce collateral requirements for non-U.S. reinsurers.¹⁹ To qualify for waiver or reduction of collateral, a non-U.S. reinsurer must meet certain minimum financial requirements. The reinsurer must have surplus in excess of \$100 million and have a secure financial strength rating from at least two nationally recognized statistical rating organizations deemed acceptable to Florida.²⁰

Subsection (3) (e) further requires the Florida Office of Insurance Regulation to consider certain domiciliary jurisdiction regulatory requirements of the assuming non-U.S. reinsurer.²¹ The required considerations include: 1) the reinsurer's domiciliary regulatory jurisdiction;²² 2) the structure and authority of the reinsurer's domiciliary regulator with regard to solvency regulation requirements and the financial surveillance of the reinsurer;²³ 3) the substance of financial and operating standards for reinsurers in the domiciliary jurisdiction;²⁴ 4) the form and substance of financial reports reinsurers are required to file in the reinsurer's domiciliary jurisdiction or other public financial statements filed in accordance with generally accepted accounting principles;²⁵ 5) the domiciliary regulator's willingness to cooperate with U.S. regulators in general and the Florida regulator in particular;²⁶ 6) the history of reinsurer performance in the domiciliary jurisdiction;²⁷ 7) documented evidence of substantial problems with enforcement of valid U.S. judgments in the domiciliary jurisdiction;²⁸ and, 8) any other matters deemed relevant by the Florida Office of Insurance Regulation.²⁹ Finally, subsection (3) (e) requires the Florida Office of Insurance Regulation to give appropriate consideration to insurer group ratings that may have been issued and in lieu of granting full credit for reinsurance, the FOIR may reduce the amount required to be held in trust under subsection (3)(c).³⁰

Subsection (3)(e) of the new Florida law and the NAIC REO Proposal share some common elements. These common elements include: 1) analysis by nationally recognized statistical rating organizations to rate non-U.S. reinsurers;³¹ 2) sharing of information with the non-U.S. reinsurer's domiciliary regulator;³² 3) evaluation of the domiciliary jurisdiction regulatory structure;³³ and, 4) consideration of any other information that may be required in the state regulator's judgment.³⁴

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III. Regulatory Challenges in Implementing Florida's New Reinsurance Collateral Requirements

Notwithstanding these similarities, Florida's adoption and implementation of subsection (3)(e) may be problematic for several reasons. First, subsection (3)(e) has vague and undefined statutory standards. The terms "secure financial rating" and "recognized statistical rating organizations" are undefined. There are no statutory standards defining what constitutes willingness to cooperate with U.S. and Florida regulators or an acceptable history of performance by non-U.S. reinsurers in their domiciliary jurisdictions. Furthermore, subsection (3)(e) does not limit the matters the Florida regulator may deem relevant in its evaluation, has no standards concerning the Florida regulator's appropriate consideration in evaluating insurer group ratings that have been issued, and does not specify standards by which the Florida regulator may reduce trust funds under subsection (3)(c) in lieu of granting credit for reinsurance.

Understandably, administrative agencies are often tasked to administer laws that at times are less precise, interact in complex ways, and must be applied to various facts and circumstances. Florida's policy regarding the use and application of subsection (3)(e) is in its formative stages due to subsection (3)(e)'s recent enactment, no known requests to the Florida Office of Insurance Regulation requesting waiver or reduction of collateral requirements,³⁵ and the status of the NAIC REO proposal.³⁶ However, because Florida's policy decisions to implement subsection (3)(e) will likely have industry-wide impact, ceding carriers, their trade associations, or reinsurers may consider filing a petition to initiate rulemaking for the purpose of establishing standards and agency policy for subsection (3)(e). The adoption of administrative agency rules to implement the provisions of section 624.610 is authorized.³⁷ Furthermore, any person regulated by an agency or having substantial interest in an agency rule may petition an agency to adopt a rule.³⁸ Therefore, petitioning for rulemaking may be a viable alternative for ceding carriers, reinsurers, and their respective trade associations to seek clear and consistent agency guidance regarding subsection (3)(e).

Finally, Florida's creation of subsection (3)(e) could impact its current accreditation status with the NAIC. Accredited states, like Florida, are required to annually submit to the NAIC an updated Financial Standards Self-Evaluation Guide that is evaluated by NAIC staff and the NAIC's Financial Regulation Standards and Accreditation Committee.³⁹ A state maintains accreditation status if it remains in compliance with the NAIC accreditation standards.⁴⁰ The NAIC's Part A accreditation standards are viewed as fundamental building blocks for sound insurance regulation.⁴¹ Part A requires state laws regarding reinsurance ceded to contain the NAIC Model Law on Credit for Reinsurance, the NAIC's Credit for Reinsurance Model Regulation and the 1992 NAIC Life and Health Reinsurance Agreements Model Regulation or substantially similar laws.⁴² Thus, implementation of subsection (3)(e) may also depend on the NAIC's determination that the addition of subsection (3)(e), alone or in conjunction with other provisions of Florida's credit for reinsurance law, satisfies Part A's requirement that state laws for reinsurance ceded be substantially similar to the above-referenced NAIC Model Laws regarding reinsurance.

Endnotes

1. Report of Task Force on Long Term Solutions for Florida's Hurricane Insurance Market at 10.
2. Id.
3. Report of Task Force on Long Term Solutions for Florida's Hurricane Insurance Market at 35.
4. Id.
5. Report of Task Force on Long Term Solutions for Florida's Hurricane Insurance Market at 36, 55.

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6. NAIC U.S. Reinsurance Collateral White Paper, December 6, 2005, at 2.
7. NAIC Joint Meeting of Executive Committee/Plenary, March 5, 2006.
8. NAIC Reinsurance Evaluation Office, Proposal to Grant Credit for Ceded Reinsurance at 3.
9. Id.
10. Id.
11. Id.
12. Id.
13. Id.
14. Id.
15. § 624.610(2), Fla. Stat. (2006).
16. § 624.610(3)(a) and (b), Fla. Stat. (2006).
17. § 624.610(3)(c), Fla. Stat. (2006).
18. § 624.610(3)(d), Fla. Stat. (2006).
19. CS/HB 1-A (2007).
20. § 624.610(3)(e), Fla. Stat. (2007).
21. Id.
22. § 624.610(3)(e)1, Fla. Stat. (2007).
23. § 624.610(3)(e)2, Fla. Stat. (2007).
24. § 624.610(3)(e)3, Fla. Stat. (2007).
25. § 624.610(3)(e)4, Fla. Stat. (2007).
26. § 624.610(3)(e)5, Fla. Stat. (2007).
27. § 624.610(3)(e)6, Fla. Stat. (2007).
28. § 624.610(3)(e)7, Fla. Stat. (2007).
29. § 624.610(3)(e)8, Fla. Stat. (2007).
30. Id.
31. NAIC Reinsurance Evaluation Office, Proposal to Grant Credit for Ceded Reinsurance at 3.

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32. NAIC Reinsurance Evaluation Office, Proposal to Grant Credit for Ceded Reinsurance at 5.
33. NAIC Reinsurance Evaluation Office, Proposal to Grant Credit for Ceded Reinsurance at 7-9.
34. NAIC Reinsurance Evaluation Office, Proposal to Grant Credit for Ceded Reinsurance at 8.
35. Panel Discussion, American Conference Institute Forum on Reinsurance Collateral, April 11-12, 2007.
36. The Reinsurance Task Force continues working on the technical details of the NAIC REO Proposal. The Reinsurance Task Force will report back to the Financial Condition (E) Committee at the NAIC's 2007 Summer National Meeting in June, followed by an overall feasibility update to the Financial Condition (E) Committee at the NAIC Fall 2007 National Meeting. No date has been set as to when the new evaluation process would be fully functional.
37. § 624.610(14), Fla. Stat. (2007).
38. § 120.54(7)(a), Fla. Stat. (2007).
39. NAIC Financial Regulation Standards and Accreditation Program, March 2007, at 7.
40. Id.
41. NAIC Financial Regulation Standards and Accreditation Program, March 2007, at 8.
42. Id. at 10.